

**TECHNICAL ASSISTANCE MATERIALS –
DRAFT FOR DISCUSSION**

MARK-TO-MARKET:

TECHNICAL ASSISTANCE MATERIALS



Office of Multifamily Housing Assistance Restructuring

**TECHNICAL ASSISTANCE MATERIALS –
DRAFT FOR DISCUSSION**

***U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF MULTIFAMILY HOUSING ASSISTANCE RESTRUCTURING***

“OMHAR”

“MARK-TO-MARKET”

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**Mark-To-Market Technical Assistance Materials:
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Introduction to the Mark-To-Market Program

The purpose of these technical assistance materials is to provide Participating Administrative Entities (PAEs) and other interested parties the basic tools for restructuring under the Mark-to-Market program.

The Multifamily Assisted Housing Reform and Affordability (MAHRA) Act of 1997 establishes a process for restructuring multifamily properties insured by the Federal Housing Administration (FHA) and receiving rental subsidy assistance under the Department of Housing and Urban Development's (HUD's) Section 8 program.

The Mark-to-Market program was created to address the reality that many of the 10,000 expiring FHA-insured Section 8 project-based properties, housing 1.6 million tenants, are subsidized above market levels, while it is estimated that 15 percent of these properties are physically or financially distressed.

What's Inside? The material highlights the following issues:

- ⇒ owner eligibility
- ⇒ role of the PAEs
- ⇒ importance of preserving affordable multifamily housing
- ⇒ data collection and verification responsibilities
- ⇒ underwriting and financing alternatives
- ⇒ loan and funding approval
- ⇒ closing and post-closing documentation
- ⇒ servicing



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I. Owner Eligibility for Participation

Each year HUD issues a Housing Notice that explains the procedures for owners to renew their Section 8 contracts. As explained in Housing Notice 98-34, the owner determines a property's eligibility for Mark-to-Market. HUD and the PAEs will use the same criteria to screen and confirm a property's eligibility.

Process. The process for preparing and executing Section 8 contracts under the Mark-to-Market program for eligible properties begins when the owner applies to the program and ends when HUD has determined eligibility. The owner files a notice with the HUD Multifamily Program Center or Hub with jurisdiction, declaring an intent to:

- (1) renew Section 8 with mortgage debt restructuring, or
- (2) renew Section 8 without mortgage debt restructuring, or
- (3) opt out.

Prior to the assignment of assets, the PAE may be asked to assist the HUD Field Office with the determination of eligibility (e.g., market rents). After assignment of assets, the PAE completes the market rental analysis, affirms owner eligibility, and coordinates Section 8 contract renewal with or without debt restructuring.

Eligible for Mark-to-Market with Debt Restructuring. Through coordination with the Field Office, properties are eligible to renew their Section 8 contracts at market rents and restructure their mortgage debts if they meet **all** of the following criteria (See Option 2 in Housing Notice 98-34):

- ⇒ multifamily housing (more than four dwelling units)
- ⇒ one or more FHA-insured or HUD-held mortgages (except Section 202)
- ⇒ receives project-based assistance (Section 8 contract)
- ⇒ project-based rents exceed comparable rents
- ⇒ owner must be in good standing

Eligible for Mark-to-Market Section 8 Rent Restructuring without Mortgage Debt Restructuring. Through coordination with the Field Office, properties that are eligible for Mark-to-Market are also eligible to renew their Section 8 contracts at market rents without mortgage debt restructuring if they meet all of the preceding eligibility criteria in paragraph 1 **plus** all of the following additional criteria (See Option 1, Method 1 in Housing Notice 98-34):

- ⇒ adequate debt service coverage after rents are adjusted down (generally with a DSCR of 1.2)
- ⇒ in good physical condition with reserves for replacement
- ⇒ competent project management

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Opt-Out. All properties are eligible to opt-out of the program at any time, provided tenants and HUD receive proper notification.

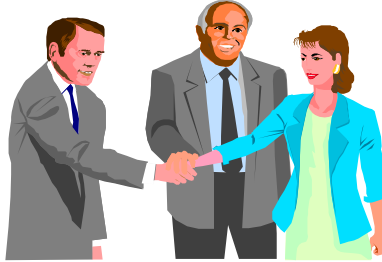
Out-Year Contracts. If some or all contracts, or stages, expire after FY 2001, the owner may request HUD to keep the out-year contracts in place without recapturing and rescinding Section 8 budget authority in return for the owner signing a Recapture Agreement requiring the owner to use excess Section 8 payments (defined as payments above the market comparable rent for assisted units) to:

- (1) fund needed rehabilitation;
- (2) repay the HUD-held second mortgage; or
- (3) repay any loan used to finance rehabilitation costs.

Ineligibility for Mark-to-Market. Some properties/owners are “**ineligible**” (e.g., non-HUD insured or rents less than market), “**exempt**” (e.g., state and local and bond financed, Section 202 elderly/disabled, FmHA Section 515 and Section 8 SROs), or “**disqualified**” (e.g., owner referred for Enforcement Center review) from the Mark-to-Market restructuring options.

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II. Role of the PAE in the Mark-to-Market Program



The hands-on restructuring responsibility is delegated to qualified entities, Participating Administrative Entities (PAEs), chosen and supervised by HUD's Office of Multifamily Housing Assistance Restructuring (OMHAR):

- ⇒ public agency preference (e.g., State and local HFAs)
- ⇒ where a public agency is not chosen, private entities can partner with public agencies (e.g., State and local HFAs, HUD)

PAE Responsibilities. Under the Project Restructuring Agreement (PRA) signed with OMHAR, the PAE has a number of responsibilities:

- ⇒ review owner eligibility (i.e., verify owner/property not ineligible, exempt or disqualified)
- ⇒ obtain public comments from tenants and community groups
- ⇒ collect and verify data
- ⇒ evaluate rehabilitation needs
- ⇒ determine type of Section 8 renewals (project-based or tenant-based assistance)
- ⇒ determine size/structure of new or modified mortgages
- ⇒ negotiate restructurings with the owner
- ⇒ assist the owners in loan/funding approval process
- ⇒ in certain cases, facilitate sale or transfer of properties
- ⇒ work with owners on closing
- ⇒ distribute closing documents

In addition, the PAE can be selected to service second mortgages, administer Section 8 contracts, and monitor compliance with Use Agreements.

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III. Preserving Affordable Housing

The goals of the Mark-to-Market program are:

- ⇒ Social: preserve affordable multifamily housing stock
- ⇒ Economic: reduce the cost of Section 8 subsidies and minimize FHA claims
- ⇒ Administrative: increase operating efficiency and ensure competent management with oversight delegated to a national network of decentralized PAEs.



The PAE plays a key role in achieving these goals, including:

- ⇒ working with tenants, local community groups, owners, OTAGs, ITAGs, and other parties to facilitate quality communication and manage competing public policy objectives necessary to effectively restructure.
- ⇒ developing a Restructuring Plan and a Rental Assistance Assessment Plan (RAAP)
- ⇒ verifying the affordability requirements through the enforcement of affordability and use restrictions if Section 8 funding ceases
- ⇒ monitoring Use Agreements
- ⇒ providing information through reporting requirements

Tenants and Community Group Participation. Two meetings will be held with tenants and community groups. The owner must notify and consult with tenants, local government officials, and other interested parties when they file a Notice of Intent to restructure and when they complete an approved Restructuring Plan.

1. A consultation meeting is required within 20 to 40 days of the date of the Notice of Intent, where tenants can comment on topics such as the physical condition of the building, rehabilitation and repairs, building management, and project-based or tenant-based assistance.
2. A second meeting will be held after the completion of the draft Restructuring Plan. The purpose of the meeting is to enable tenants and community groups to provide feedback prior to submission of the Restructuring Plan to OMHAR.

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Other Tenant and Community Group Participation:

Intermediary Technical Assistance Grant Programs (ITAG). \$9 million was allocated for Intermediaries to administer this technical assistance program around the country. Grants include: Resident Capacity Grants; Predevelopment Grants; and Public Entity Grants. ITAG activities include, among others:

- ⇒ advertise funding availability for state-grouping
- ⇒ produce and distribute grant application kits
- ⇒ accept applications
- ⇒ review and approve or reject applications
- ⇒ Disburse grants to sub-recipients

Outreach and Training Grants (OTAGs). 32 OTAG grantees were selected to organize and train tenants to participate meaningfully in the Mark-to- Market restructuring process. OTAG activities can include, among others:

- ⇒ Identify residents and resident groups living in eligible Mark-to-Market properties
- ⇒ Provide outreach and training to such tenants, explain the Mark-to-Market program, educate tenants on possible financial changes and possible repairs
- ⇒ Organize residents
- ⇒ Counsel residents to sound housing management, maintenance, and financial management

VISTA. HUD signed a Memorandum of Understanding with the Corporation for National and Community Service which included \$1 million a year during each of the next three years to hire approximately 100 VISTA volunteers annually to help organize and train tenants in Mark-to-Market eligible properties.

Other Resources. Additional activities will include:

- ⇒ teleconferences broadcast to all HUD Field Offices for all Mark-to-Market stakeholders (tenant associations, nonprofits, public entities, state or local government, PAEs, owners, etc.);
- ⇒ on-site two day conferences in states with the greatest number of eligible Mark-to-Market properties;
- ⇒ a national directory of all Mark-to-Market stakeholders;
- ⇒ a Technical Assistance Interactive website; and
- ⇒ three brochures to aide tenants, owners and others understand the Mark-to-Market program.

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RAAP. One of the key roles of the PAE is to use the RAAP to determine whether Section 8 assistance remains project-based or is converted to tenant-based assistance. The RAAP must assess the impact of converting to tenant-based assistance or extending project-based assistance.

A property receives mandatory project-based assistance if it is:

- ⇒ in a tight rental market (vacancy rates of 6 percent or below)
- ⇒ predominantly occupied by elderly or disabled families (at least 50 percent)
- ⇒ held by a nonprofit cooperative ownership housing corporation or a nonprofit cooperative housing trust.

Use Agreement. Every property that has debt restructured will be subject to the affordability and use restrictions in a Use Agreement, which statutorily must be in effect for at least 30 years (e.g., preserve residential housing, ensure safety and health standards, document affordability requirements, provide enforcement rights).



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IV. Data Collection and Verification

In preparation for underwriting, the **owner** has 30 days to provide estimates of projected revenue, expenses, and rehabilitation needs prior to Section 8 contract expiration. The following checklist includes required materials the owner must provide the PAE. PAEs may request additional information.

1. Documentation

- ☐ ownership documents
- ☐ related party agreements (if any)
- ☐ Management Agreement/HUD Management Certificate (if not available from HUD)
- ☐ audited financial statements for the past 3 years (if not available from HUD)
- ☐ insurance policies (e.g., hazard, property, flood)
- ☐ rent roll

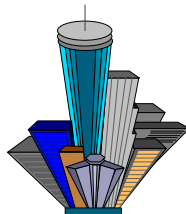
2. Financial Analyses and Projections

- ☐ A one-year project rent and expense analysis to size the first mortgage
- ☐ Optional: owners are invited to submit two 20-year pro formas (*one with and one without Section 8 assistance*), to size the second mortgage -- assumptions for each may differ. If the owner does not do this, the PAE develops it.

Use the following guidelines:

A. *Revenue Estimates -- using Comparable Market Rents:*

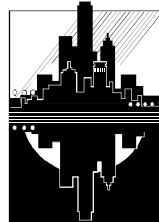
- ⇒ Calculate market rent based on three comparable, unsubsidized properties in same market area.
- ⇒ If three or more comparable properties cannot be located in the same market area, expand to non-comparable properties in the same area.
- ⇒ If three or more comparable properties cannot be located in the same market area, expand to neighboring areas.
- ⇒ As a LAST RESORT, use the 90 percent of FMR standard.
- ⇒ Reflect the impact of rent control and zoning restrictions.
- ⇒ Use lower of comparable market rent and affordable rent standard.
- ⇒ Identify the vacancy and bad debt assumptions.
- ⇒ Include revenue from commercial leases to the extent it is clearly reliable (i.e., a conservative estimate).
- ⇒ Specify market revenue trending assumptions.



Trumpet Tower



Business Offices



Government Center



Unassisted Multifamily Housing

The first three are not appropriate for comparable market rent comparisons.

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B. *Operating Expense Estimates*: Determine competitive market rate operating expenses and adjust for “other necessary” expenses for the property’s operation as a subsidized property:

- ⇒ Identify management fees, salaries, benefits, and other management costs (e.g., rent-free units).
- ⇒ Analyze utility costs (e.g., if property-paid utility costs are not included in the comparable market properties, make an upward adjustment).
- ⇒ Show taxes, insurance and tax abatements, and explain.
- ⇒ Separate Reserves for Replacement deposits from maintenance expenses.
- ⇒ Specify market expense trending assumptions (pro formas only).
- ⇒ Explain other necessary expenses (e.g., costs that are not included in the comparable market properties).

C. *NOI Projections*: (from revenue and expense projections).

3. Physical Condition Assessment (PCA): The owner engages a qualified inspector to develop a PCA (or updated CNA), and the PAE performs an independent evaluation of the following:

- ☐ immediate physical needs (within next 12 months)
- ☐ long-term physical needs (not now, but within 20 years)
- ☐ analysis of Reserves for Replacement

***Note:** If health and safety violations exist, the owner in violation of the Section 8 HAP contract and the FHA Regulatory Agreement; all such work items must be corrected as soon as they are identified

4. Financing plan. The owner must propose a plan for restructuring the property’s mortgage debt and for refinancing rehabilitation costs.
5. Location Map, Title Report, Site Survey, if available.
6. Real Estate Appraisal. If the owner intends to apply for FHA mortgage insurance under Section 223(f), the mortgagee should submit a real estate appraisal from an approved appraiser.

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The **P**AE verifies the information with independent data, qualified professionals, and consultations with affected parties. Use this due diligence checklist, where appropriate:



1. Review Documentation

- ☐ Field Office records and certification for the:
 - ⇒ project and property
 - ⇒ ownership and management
 - ⇒ security and assistance
 - ⇒ loan and other financial information
- ☐ Lender records (from mortgagee or loan servicer)
- ☐ Local government records (compliance issues), if available

2. Due Diligence for Revenue Projections

- ☐ Procurement of qualified appraiser
- ☐ Set the scope and standards of the appraisal
- ☐ Use standards of market-comparable improvements and appropriateness of comparable market rents

3. Due Diligence for Operating Expense Projections

- ☐ Review expense data sources
- ☐ Determine other necessary expenses
- ☐ Categorize expense data (with and without project-based Section 8)
- ☐ Compare to appraisal results and analyze variances

4. Due Diligence for Rehabilitation Requirements

- ☐ Consult with tenants and other interested parties
- ☐ Establish the scope of work, review, and revise the PCA, in consultation with the property inspector
- ☐ Estimate rehabilitation costs (using qualified inspector)

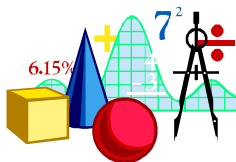
5. Certification by PAE

- ☐ Complete environmental restrictions and assessment and review of PCA
- ☐ Certify to the OMHAR Field Office the accuracy of the: (1) PCA, (2) “Environmental Restrictions Checklist”, and (3) “Environmental Assessment and Compliance Findings for Related Laws”

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V. Underwriting and Financing Alternatives

Role of the Underwriter. The Underwriter uses the Limited Scope Appraisal (or full appraisal), financial statements, rent/expense analyses and pro formas, PCA, third-party expense information, management documents, and other available sources to: determine a property's rents, expenses and rehabilitation needs; recommend and justify exception rents if necessary; evaluate management; and recommend the size of the first mortgage, the second (cash flow) mortgage (and third mortgage if needed), the amount of claim payable by FHA, determine rehabilitation financing requirements, and the owner's financial return.



The underwriter analyzes stabilized revenues/expenses to size the first mortgage, and develops a 20-year projection of revenues/expenses to size the second mortgage. For the 20-year projection, the underwriter evaluates two scenarios: (1) project-based Section 8 is continued indefinitely at market rates, and (2) project-based Section 8 is discontinued.

Calculation of Adjusted Net Operating Income: One of the first steps in the financial analysis is the calculation of Adjusted Net Operating Income (NOI):

Add the Revenues:	<ul style="list-style-type: none"> + Rental Income (comparable market rent data/affordable rent standard) + Commercial Income (include in "other income") + Other Income (e.g., laundry, parking, cable TV) - Vacancy/Bad Debt Allowance (deduct from gross revenue potential)
Subtract Operating Expenses:	<p>[Note: operating expenses may vary based on whether assistance is project-based or tenant-based.]</p> <ul style="list-style-type: none"> - Management fees (compare agreement to actual fee) - Other necessary expenses (e.g., Service Coordinators, security, tenant income verification, Neighborhood Networks (to extent included in the FHA approved Business Plan)) - Monthly deposits to Reserves for Replacement (treat the monthly deposits as an operating expense for underwriting purposes)*
NET OPERATING INCOME (NOI)	<p>= Total Revenues minus (-) Total Operating Expenses</p> <p>⇒ <u>if positive</u>, underwriter determines sustainable first mortgage debt, generally using a 1.2 DSCR</p> <p>⇒ <u>if negative</u>, underwriter may recommend exception rents</p>

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Exception Rents: If the adjusted NOI is negative, or if the cost of HUD funded rehabilitation is greater than the debt supported by the NOI after restructuring, the underwriter may recommend exception rents. Exception rents are based on the projected costs of operation, assuming no first mortgage debt service, and using a reasonable allowance for second mortgage debt service coverage, and owner return. Exception rents may not exceed 120 percent of the area's FMR without a waiver from OMHAR Headquarters, and generally may not be used in more than 20 percent of the PAE's portfolio.

Determination of Rehabilitation Needs: The underwriter confirms the property's immediate deferred maintenance, market driven capital needs, and long-term capital needs to estimate the Rehabilitation Escrow and Reserves for Replacement by assessing:

- (1) Owner's evaluation of needs (work closely with the PAE's inspector)
- (2) Housing Quality Standards (confirm no health and safety threats)
- (3) Confirm that restoration is to the non-luxury standard adequate for the market at the property's original purpose.
- (4) Estimate Rehabilitation Escrow as follows:
 - ⇒ if less than substantial rehabilitation, 100 percent of the cost in cash plus 50 percent in either cash or a letter of credit
 - ⇒ if substantial rehabilitation, either 100 percent performance/payment bond or a 15 percent cash escrow with a 10 percent holdback until cost certification review is completed
 - ⇒ As defined in HUD Handbook 4460.1, Chapter 4: "substantial rehabilitation" is defined as: required repairs, replacements and improvements involving (1) the replacement of 2 or more major building systems, or (2) costs which exceed either 15 percent of the properties replacement cost or \$6,500 per unit (times the area high cost factor)
- (5) Long-term capital needs to maintain physical integrity for next 20 years
- (6) Reserves for Replacement (estimate initial and monthly deposits) -- **do not double count** items in Rehabilitation Escrow in Reserves for Replacement
- (7) Confirm owner's contribution to Rehabilitation Escrow is at least 20 percent of rehabilitation costs (a minimum of three percent from non-governmental sources)
- (8) Cost-benefit analysis for each discretionary major work item in the Plan
- (9) Ensure Restructuring Plan complies with applicable accessibility requirements



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Evaluation of Management and Other Issues: The underwriter identifies/evaluates property management, reviews title and insurance policies, and evaluates compliance with zoning and environmental laws and regulations:

- ⇒ Identify management agent (*owner/manager or self-management; identity of interest management; independent fee agent; property administrator*)
- ⇒ Assess management through review of tenant and community comments, HUD Field Office comments and files, physical and financial condition of the property.
- ⇒ Ensure management has a fidelity bond in an amount equal to at least two months' potential rent collections per property
- ⇒ Review a sample of accounting and tenant files
- ⇒ Include Property Management Standards in the Restructuring Plan

Property Management Standards include:

- ⇒ Protect the physical integrity of the property over the long term
- ⇒ Ensure that the building and grounds are routinely cleaned
- ⇒ Protect the financial integrity of the property
- ⇒ Take measures to ensure the tenant's physical safety

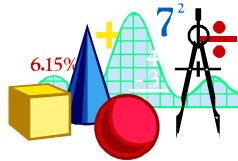
First Mortgage Financing Alternatives. After completing the information analysis, the underwriter discusses preliminary findings with the owner and the existing mortgagee, or the proposed new lender for a take-out mortgage. On the first mortgage, the owner can obtain either a loan modification or take-out loan as follows:

- ⇒ *Loan Modification.* Only available with approval of the FHA-insured mortgagee; Cannot be used to finance rehabilitation or transaction costs. The owner will negotiate with the mortgagee for any combination of the following:
 - (a) interest rate reduction
 - (b) principal write-down or
 - (c) reamortization
- ⇒ *Conventional Take-Out.* The owner should obtain a "Conditional Letter of Intent" from an approved lender as evidence of loan commitment.
- ⇒ *Take-Out under Section 542(c) HFA Risk-Sharing or Section 542(b) GSE Risk-Sharing.* Will require a technical review by OMHAR if there is a conflict of interest.

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⇒ *Take-Out with Full FHA Insurance.*

- ⇒ Section 223(a)(7) – limited for Mark-to-Market restructurings to the amount of the current UPB (401.460(a)) and an amortization period equal to the remaining term (plus up to 12 years); requires a minimum DSCR of 1.2 (for mark-to-market restructurings)
- ⇒ Section 223(f) – limited to 85 percent of the appraised value or 70 percent of the cost to refinance (35 year mortgage term); eligible for financing moderate rehabilitation
- ⇒ Section 221(d)(4) – requires FHA Field Office processing approval; PAE to closely coordinate with FHA underwriters (term of 40 years); eligible for substantial rehabilitation, but has LTV requirements of 90 percent.



NOI Recalculation. The underwriting concludes with the sizing of the first and second mortgages (and the third mortgage, as needed), determining the Rehabilitation Escrow, and the deposits to the Reserves for Replacement. Before recommending the Restructuring Plan the PAE should recalculate the NOI to assure consistency with the refinanced first mortgage terms and to reflect changes dictated by the PAE's internal review process.

If NOI is positive, use one of the following restructuring approaches:

- ⇒ mortgage modification with a partial payment of claim (leaving at least a nominal mortgage amount);
- ⇒ new financing with a partial payment of claim (leaving at least a nominal mortgage amount); or

If NOI is negative, or the property NOI cannot support the cost of rehabilitation with a full pay-down of existing debt, recommend the most cost-effective option:

- ⇒ above market exception rents with a partial payment of claim (leaving only a nominal mortgage amount); or
- ⇒ conversion to tenant-based Section 8 assistance, provided it will not adversely impact tenants.

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Sizing the First Mortgage. The underwriter should assume the first mortgage will be fully amortizing with fixed monthly payments on competitive terms; and is equal to the supportable debt (assuming an adequate debt service coverage ratio, generally 1.2 unless the supportable debt is small, or conventional financing LTVs dictate a higher DSCR; generally, OMHAR will allow up to 1.4 DSCR). A waiver is required to use greater than 1.4 DSCR unless it is necessary to constrain the LTV to less than 100%. The plan cannot produce a principal balance on the first mortgage that exceeds the existing unpaid principle balance of the first mortgage at the time of restructuring. The principal amount should be sustainable at rent levels that are the lower of: (1) Section 8 rents under Mark-to-Market, or (2) affordable rents allowed under the Use Agreement.

To size the first mortgage, the underwriter considers the following:

- ⇒ **Debt Service Coverage Ratio.** Generally, a DSCR of 1.2 is applied to NOI to determine “supportable debt”. If necessary, the PAE may increase the DSCR up to 1.4 to accommodate conventional financing, or to decrease the risk of default for relatively small take-out loans. Additionally, the LTV may dictate a higher DSCR. In no cases, however, will an LTV greater than 100 percent be approved.
- ⇒ **Non-FHA Insured Take-Out.** If the DSCR required by the new lender is greater than the OMHAR standard for approving the PPC, the owner must either pay the difference or obtain alternative financing.
- ⇒ **Modified Loan or FHA-Insured Take-Out.** Generally, apply a DSCR of 1.2.
- ⇒ **Transaction Costs.** Generally, HUD will increase PPC to allow 50 percent of the transaction costs in a new take-out loan. No transaction costs can be included on a modification.
- ⇒ **Other.** Consider the strength and depth of the market, and amortization period dictated by condition of the project (i.e., remaining physical or economic life).
- ⇒ **Principal and Interest.** Base supportable debt on competitive interest rate, term, and full amortization.
- ⇒ **Restructured First Mortgage.** Loan amount is equal to the supportable debt.
- ⇒ **Sizing the Partial Payment of Claim.** Sized at the lesser of the:
 - ⇒ original principal balance of the existing mortgage, or
 - ⇒ sum of UPB, rehabilitation and transaction costs; minus supportable debt, owner contributions, excess funds, and residual receipts.

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Sizing the Second Mortgage. The subordinate mortgage is superior to all liens on the property, except the modified or new restructured first mortgage or any HUD-held or insured mortgage in place before the restructuring. The second mortgage is sized at the lesser of:

- (1) the difference between the unpaid principal balance before and after restructuring, and
- (2) an amount the PAE determines the property can reasonably repay, using the following criteria:
 - ⇒ Anticipated Net Cash Flow. If project-based assistance, 75 percent of net cash flow (after payment of first mortgage debt service) is paid on the principal and interest; OMHAR may permit owner to keep up to 25 percent
 - ⇒ Trending Assumptions. Apply OCAFs to the previous year's rent.
 - ⇒ Maturity Date. Usually same as restructured first mortgage.
 - ⇒ Interest Rate on Second Mortgage. Minimum 1 percent; simple, not compounded, interest.
 - ⇒ Application of loan payments. Accrued interest, then principal.
 - ⇒ Anticipated Residual Value and Appreciation Potential. At the end of the term.
 - ⇒ Ability of Property to Refinance Second Mortgage. At end of term.
 - ⇒ Terms of the Recapture Agreement (if applicable). Excess payments not used to pay for rehabilitation or new first non-FHA insured mortgage.

Sizing the Third Mortgage. If the partial payment of claim is greater than the second mortgage, HUD will require a subordinate third mortgage. It will bear interest at the same rate as the second mortgage and will require no payments except payment in full when the second mortgage is paid in full. The PAE may negotiate forgiveness of a portion of this debt, up to 30 percent to recognize imputed tax consequences of restructuring.

Estimating Rehabilitation Costs and Requirements for Reserves. The owner is responsible for obtaining rehabilitation financing. The underwriter determines the Rehabilitation Escrow Account funding requirement, and the size of the initial and annual/monthly deposits for the Reserves for Replacement Account. The PAE must require repairs due within 12 months to be escrowed (and obtain owner contribution from non-property resources) rather than deferred to be funded through monthly Reserves for Replacement deposits.

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Financial Return to Owner. The Restructuring Plan may provide up to 25 percent of the net cash flow to be paid to an owner that meets management and quality standards, held in Escrow until HUD or the PAE determines the property is in compliance. The Plan may also include a one-time distribution of up to 10 percent after the rehabilitation work is completed satisfactorily. Where exception rents are used, the underwriter should ensure a slightly positive NOI. HUD will consider paying an asset management fee up to \$25 PUPM, provided the owner agrees to a payment schedule for the second mortgage and remains current with that schedule. Further, the property must have received superior ratings from REAC on the most recent ratings. This fee cannot accrue.



Draft Restructuring Plan. Within 30 days after the PAE notifies the OMHAR Field Office that all data collection and due diligence has been completed, the underwriter completes the draft Restructuring Plan by developing a Case Memorandum. The Case Memorandum explains the restructuring conclusions (e.g., NOI projections, sizing of the mortgages, rehabilitation needs, and the owner's return).

The Plan should be submitted to the PAE's Loan Committee concurrently with the tenant/public review/meeting process. The following list is a complete inventory of the required elements:

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Draft Restructuring Plan Checklist

<input type="checkbox"/> Narrative Summary	<input type="checkbox"/> Estimate of Financial Returns to Owner (up to 25% of anticipated net cash flows)
<input type="checkbox"/> Limited Scope Appraisal (or full appraisal, if applicable) Conclusion	<input type="checkbox"/> Determination of Restructured Rents, including Recommendation for Exception Rents, if applicable.
<input type="checkbox"/> Physical Condition Assessment (PCA) Conclusion	<input type="checkbox"/> Determination of Project-based or Tenant-based Section 8, including Rental Assistance Assessment Plan (RAAP), as needed
<input type="checkbox"/> First, Second, and if necessary, Third Mortgage Conclusions	<input type="checkbox"/> Description of Affordability and Use Requirements
<input type="checkbox"/> Recommended Partial Payment of Claim amount	<input type="checkbox"/> Documentation of Tenant Notifications
<input type="checkbox"/> Rehabilitation Escrow Requirement	<input type="checkbox"/> Proposed Restructuring Commitment
<input type="checkbox"/> Reserves for Replacement Initial and Monthly Deposit	<input type="checkbox"/> Summary of Tenant and Local Community Comments
<input type="checkbox"/> Determination of Compliance with Environmental Reviews	<input type="checkbox"/> Application for FHA Firm Commitment or Firm Approval Letter (if applicable)
<input type="checkbox"/> Determination of Compliance with Subsidy Layering Reviews	

For negotiating purposes, the PAE considers tax implications, certifies the Restructuring Plan, and determines the affordability requirements in the Use Agreement.

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

Conforming Versus Non-Conforming Transactions. The underwriter uses the following criteria to evaluate the Restructuring Plan transaction; OMHAR makes the final determination:

- Conforming:** It must meet **ALL** of the following criteria:
- ⇒ supportable first mortgage is at least 60 percent of the UPB on the original first mortgage
 - ⇒ new restructured mortgage does not exceed \$5 million
 - ⇒ write down does not exceed \$5 million
 - ⇒ rehabilitation costs per unit of \$5,000 or less
 - ⇒ does not involve PAE as lender or provider of credit enhancement
 - ⇒ no conflicts of interest between the owner and the PAE
 - ⇒ is not one of the first three to five transactions performed by the PAE
 - ⇒ the net present value of savings to Section 8 exceeds write-down
 - ⇒ no waivers are being requested
 - ⇒ PAE has not received a warning letter regarding performance from OMHAR

Non-conforming. It fails to meet **any one** of the criteria for a conforming transaction.

Conforming Transaction: Administrative Review. If the Restructuring Plan package is conforming, the OMHAR Field Office performs an administrative review of the completed Restructuring Plan package (within 7 business days of submission of all documents) to ensure that the Restructuring Plan includes all the required documents and certifications needed for post-closing audit and evaluation. The administrative review includes:

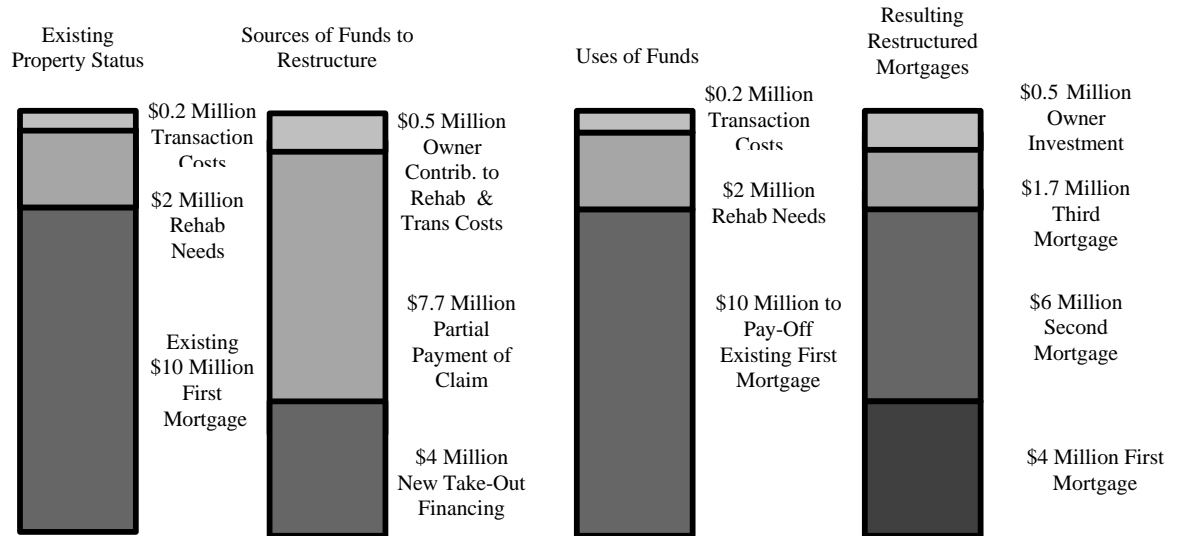
- ⇒ Case Memorandum
- ⇒ First Mortgage Conclusion
- ⇒ Second Mortgage Conclusion (Partial Payment of Claim)
- ⇒ Determination of Rehabilitation Needs
- ⇒ Restructuring Commitment

Non-Conforming Transaction – Technical Review. If it is non-conforming, the OMHAR Field Office performs a technical review (within 14 business days of submission of all documents). In addition to a thorough “desk review,” the technical review includes site visits, where practical, by OMHAR Field Office staff and HUD multifamily field staff, as needed. In addition to covering the same elements as the administrative review, the technical review should include (but is not limited to) an assessment of:

- a) the balance between the financial and non-financial goals of the Mark-to-Market program;
- b) compliance with the underwriting standards of Mark-to-Market;
- c) adequacy and reasonableness of the scope and cost of repairs, and their consistency with the Rehabilitation Escrow and the deposits to the Reserves for Replacement;
- d) quality and consistency among the PCA, Limited Scope Appraisal and any additional engineering or environmental reports; and
- e) reasonableness of transaction costs.

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

SAMPLE TRANSACTION: NEW MORTGAGE WITH PARTIAL PAYMENT OF CLAIM



SOURCES AND USES

	<u>PPC</u>	<u>New Debt</u>	<u>Owner Contributions</u>	<u>Total Uses</u>
Satisfy Outstanding Debt	\$7.6 million	\$2.4 million	- 0 -	\$10.0 million
Rehabilitation Costs	- 0 -	\$1.6 million	\$400,000	\$2.0 million
Owner Transaction Costs	- 0 -	- 0 -	\$100,000	\$100,000
HUD Transaction Costs	\$100,000	- 0 -	- 0 -	\$100,000
TOTAL SOURCES:	<u>\$7.7 million</u>	<u>\$4.0 million</u>	<u>\$500,000</u>	<u>12.2 million</u>

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

VI. Loan and Funding Approval Process

Prior to obtaining loan/funding approval, the underwriter reviews data for completeness and accuracy; determines property ownership structure; identifies and evaluates compliance with HUD guidelines; and verifies financial statements and other owner-provided information. Documentation used to develop the Restructuring Plan includes:



Required Materials

<input type="checkbox"/> Rider to Section 8 Contract (signed by Owner)	<input type="checkbox"/> Limited Scope Appraisal and List of Market-Comparable Improvements
<input type="checkbox"/> Location Map	<input type="checkbox"/> Full Appraisal submitted by Owner only if applying for FHA mortgage insurance under Sections 223(f) or 221(d)(4)
<input type="checkbox"/> Data collection checklist and schedule	<input type="checkbox"/> PCA (or current PNA and Analysis of Reserves for Replacement)
<input type="checkbox"/> Ownership documentation	<input type="checkbox"/> HUD's Environmental Restrictions checklist
<input type="checkbox"/> Related party agreements (if any)	<input type="checkbox"/> HUD's Environmental Assessment and Compliance Findings for Related Laws Report
<input type="checkbox"/> Signed original Previous Participation Certificates (HUD 2530) on all principals	<input type="checkbox"/> PAE Certification of Accuracy and Completeness of PCA and Environmental Reports
<input type="checkbox"/> Audited Financial Statements for most recent three years (if not available from the Field Office)	<input type="checkbox"/> Data Release Authorization Letter from Owner to Lender
<input type="checkbox"/> Title Policy or Pro Forma (if submitted by owner)	<input type="checkbox"/> Third-Party Expense Comparable Data provided by PAE
<input type="checkbox"/> Property Rent and Expense Analysis and Pro Formas	<input type="checkbox"/> Management Agreement/HUD Management Certification
<input type="checkbox"/> Insurance policies	<input type="checkbox"/> Notice to Tenants, other interested parties of consultation meeting
<input type="checkbox"/> Rent roll	<input type="checkbox"/> PAE Confirmation of Completeness of Data Collection
<input type="checkbox"/> HUD Field Office's Asset Management Records	
<input type="checkbox"/> Owner's Financing Plan	

Other Documents that May be Requested or Provided, if Available:

<input type="checkbox"/> Site Survey	<input type="checkbox"/> Property Tax Assessment bill
<input type="checkbox"/> Easements and Use Agreements	<input type="checkbox"/> Tax Returns for most recent three years
<input type="checkbox"/> Service contracts	<input type="checkbox"/> Lender's Loan Servicing and Property Inspection Records
<input type="checkbox"/> Commercial leases	<input type="checkbox"/> Confirmation of zoning compliance
<input type="checkbox"/> Utility bills	

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

Review of Restructuring Plan. The PAE's loan committee conducts an internal review of the underwriter's Restructuring Plan (and the "fast-track" mortgage request, if applicable) along with the draft Restructuring Commitment, before forwarding to the OMHAR Field Office. The PAE ensures *consistency, completeness and compliance* with the requirements, and resolves any inconsistencies between the recommended Restructuring Plan and the owner's financing plan.

Cost-Effectiveness Analysis: PAEs are required to review the Restructuring Plan to determine the cost effectiveness of all repair items. This determination is intended to ensure particular scrutiny by the PAE of those projects with significant rehabilitation needs, and to ensure that other less costly approaches (either in scope of work, or by recommending rejection of the Restructuring Plan) are considered. OMHAR expects the PAE to exercise judgment in balancing the competing economic and social objectives in every case, rather than relying on an "objective" standard set by HUD. In each case, the impact on tenants and the community will be considered prior to HUD's decision.



Restructuring Commitment. The PAE drafts a Restructuring Commitment, incorporating the conclusions of the Case Memorandum, Underwriting determinations, PCA, RAAP, Use Agreement, and other materials. It should include the following:

- ⇒ Section 8: HAP and/or ACC; Assisted Units; Contract Rents; and Term
- ⇒ First Mortgage/Loan Modification: Principal; Interest; Term; Debt Service; Type/Source of financing
- ⇒ Partial Payment of Claim: Amount as of date certain
- ⇒ Second Mortgage: Principal; Interest; Term; Debt Service
- ⇒ Third Mortgage: Principal; Interest; Term
- ⇒ Rehabilitation Needs: Rehabilitation Escrow; Owner's Contribution; Other Sources of Financing; Initial Deposit to Reserves for Replacement; Annual Deposit to Reserves for Replacement
- ⇒ Use Agreement: Affordable Rents; Term
- ⇒ RAAP: Tenant-based/Project-based
- ⇒ Owner Distributions: Escrow Requirements; One-time Distribution

When discrepancies and inconsistencies are resolved, the PAE provides certification of completion of the Restructuring Plan, and (along with the mortgagee) certification of the FHA underwriting to the OMHAR Field Office.

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

The OMHAR Field Office. After drafting Restructuring Commitment the PAE should forward a copy to the OMHAR Field Office after providing a notice that describes the completed Restructuring Plan and the Restructuring Commitment, and holding the required second meeting with tenants and local community groups. The notice should be provided to every tenant, the owner, the mortgagee or loan servicer, and the chief executive officer of the affected unit of local government.

OMHAR reviews the materials, and approves or rejects it.

Plan approved: If approved, the owner has 30 days to accept or reject the Restructuring Commitment.

Plan rejected: The owner has 10 days after rejecting the Restructuring Plan to appeal to the PAE for a hearing.

OMHAR ensures the materials are complete, alerts HUD Multifamily HUB or Field Office, and the Public Housing Division when there is a pending conversion to tenant-based assistance, reviews conforming (administrative review) and non-conforming (technical review) transactions, and reviews the FHA loan application, if applicable.

TECHNICAL ASSISTANCE MATERIAL -- DRAFT FOR DISCUSSION

VII. Closing Documents

Within 60 days of the execution of the Restructuring Commitment, the PAE and the PAE's attorney should complete all closing documents and prepare their distribution.

Closing Docket Content Checklist

	<i>Modification of Existing FHA Loan</i>	<i>Refinance with New FHA Insurance</i>	<i>Refinance with New Conventional Loan/Risk Sharing (542c)</i>	Completed
First Mortgage Documents				
1. Assumption and Modification of Note and Mortgage	✓			
2. Assumption and Modification of Regulatory Agreement	✓			
3. Assumption and Modification of Security Agreement (if applicable)	✓			
4. Acknowledgment (as mortgage insurer) on Modification of FHA-insured Note	✓			
5. Signatory (as mortgagee) Modification of HUD-held Note and Mortgage	✓			
6. UCC-3 Statements of Assignment (if sale)	✓			
7. UCC-3 Termination statements		✓	✓	
8. Certification of Mortgage Balance	✓	✓		
9. First mortgage application	✓			
10. Release of mortgage		✓	✓	
11. Modification of regulatory agreement	✓	✓	✓	
12. New regulatory agreement		✓	✓	
13. Modification of security agreement	✓			
14. Release of security agreement (if applicable)		✓	✓	
15. Mortgagee's payoff letter		✓	✓	
16. Section 223(a)(7) closing documents with (a)(7) closing checklist (if applicable)		✓		
17. Risk sharing (542(c)) closing documents with checklist (if applicable)			✓	
18. Section 223(f) closing documents with (f) closing checklist (if applicable)		✓		
19. HUD 290		✓		
20. Collateral assignment of HAP contract (if required by mortgagee)		✓	✓	
21. Termination of multifamily insurance			✓	
22. Conventional loan documents			✓	
Second Mortgage Documents				
1. Mortgage restructuring note	✓	✓	✓	
2. Mortgage restructuring mortgage (HUD State Form)	✓	✓	✓	
3. Rider to mortgage restructuring mortgage	✓	✓	✓	
4. Mortgage restructuring financing statements	✓	✓	✓	
Third Mortgage Documents (if applicable)				
1. Shared proceeds note	✓	✓	✓	
2. Shared proceeds mortgage	✓	✓	✓	
3. Rider to shared proceeds mortgage	✓	✓	✓	
Rehabilitation Funding Documents				
1. List of required repairs	✓	✓	✓	
2. Agreement to perform repairs/escrow deposit agreement (property and owner funds)	✓	✓	✓	

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

Closing Docket Content Checklist (con't)

	<i>Modification of Existing FHA Loan</i>	<i>Refinance with New FHA Insurance</i>	<i>Refinance with New Conventional Loan/Risk Sharing (542c)</i>	<i>Completed</i>
Use Agreement				
1. Restructuring use agreement	✓	✓	✓	
Section 8 Documents				
1. Section 8 housing assistance payments contract	✓	✓	✓	
2. Section 8 recapture agreement (if applicable)	✓	✓	✓	
3. Assignment of rights in and to HAP contract (if sale of property)	✓	✓	✓	
4. ACC between HUD and Contract Administrator	✓	✓	✓	
Additional Documents				
1. Certification re: Notice and Administrative Actions	✓	✓	✓	
2. Certification re: Sources and Uses of funds statement	✓	✓	✓	
3. Certification (from PAE) of Closing to OMHAR Field Office Director	✓	✓	✓	
4. Sources and uses of funds statement	✓	✓	✓	
5. Title evidence (endorsement of existing or new title insurance policy)	✓	✓	✓	
6. Opinion of owner's counsel	✓	✓	✓	
7. Transmittal letter to field office	✓	✓	✓	
8. Subordination agreement (1 st mortgagee and 2 nd mortgagee, if applicable)	✓	✓	✓	
9. Transfer of Physical Assets (TPA) documents	✓	✓	✓	
10. Wiring Instructions	✓	✓	✓	
11. HUD form required for release of funds in the reserves for replacement account	✓	✓	✓	
12. Agreement to increase replacement Reserves deposits	✓	✓	✓	
13. HUD Form 9250 funds authorization	✓	✓	✓	
14. Consent of first mortgage	✓	✓	✓	
15. Copy of certificate of occupancy	✓	✓	✓	
16. Building permit for repairs	✓	✓	✓	
17. Amendment to organizational documents	✓	✓	✓	
18. Evidence of insurance	✓	✓	✓	
19. Rent schedule (HUD Form 92458)	✓	✓	✓	
20. Recordation agreement	✓	✓	✓	
21. List of attendees (Closing Parties List)	✓	✓	✓	

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

VIII. Post-Closing Document Distribution

HUD Required Closing Document Distribution Checklist

ORIGINALS of ALL documents are sent to the Washington Docket; Certain documentation requirements also exist for the Servicer of the 2nd/3rd mortgage(s), Rehabilitation Escrow agent, Section 8 contract administrator, and Use Agreement monitor.

DUPLICATES of ALL documents are sent to the HUD Field Office, the HUD Attorney Docket, the OMHAR HUB Docket, and the PAE Docket.

	Servicer of 2 nd /3 rd mortgage documents	Completed
First Mortgage Documents		
1. Assumption and Modification of Note and Mortgage	--	
2. Assumption and Modification of Regulatory Agreement	--	
3. Assumption and Modification of Security Agreement (if applicable)	--	
4. UCC-3 Statements of Assignment (if sale)	--	
5. UCC-3 Termination statements	--	
6. Certification of Mortgage Balance	--	
7. First mortgage application to HUD for partial settlement and application of insurance benefits	--	
8. Release of mortgage	--	
9. Modification of regulatory agreement	--	
10. Modification of security agreement	--	
11. Release of security agreement (if applicable)	--	
12. Mortgagee's payoff letter	--	
13. Section 223(a)(7) closing documents with (a)(7) closing checklist (if applicable)	--	
14. Risk sharing (542(c)) closing documents with checklist (if applicable)	--	
15. Section 223(f) closing documents with (f) closing checklist (if applicable)	--	
16. HUD 290	--	
17. Collateral assignment of HAP contract (if required by mortgagee)	--	
18. Termination of multifamily insurance	--	
19. Conventional loan documents	--	
Second Mortgage Documents		
1. Mortgage restructuring note	O	
2. Mortgage restructuring mortgage (HUD State Form)	O	
3. Rider to mortgage restructuring mortgage	O	
4. Mortgage restructuring financing statements	O	
Third Mortgage Documents (if applicable)		
1. Shared proceeds note		
2. Shared proceeds mortgage		
3. Rider to shared proceeds mortgage		
Rehabilitation Funding Documents		
1. List of required repairs		
2. Agreement to perform repairs/escrow deposit agreement (property and owner funds)		

KEY: O - Original; D - Duplicate

TECHNICAL ASSISTANCE MATERIALS – DRAFT FOR DISCUSSION

HUD Required Closing Document Distribution Checklist (con't)

ORIGINALS of ALL documents are sent to the Washington Docket; Note, this list different than above in terms of required documentation for the HUD Field Office and the HUD FAD.

DUPLICATES of ALL documents are sent to the HUD Attorney Docket, the OMHAR HUB Docket, and the PAE Docket.

	HUD F.O. Docket	HUD FAD S.8 documents	Completed
Use Agreement			
1. Use Agreement	O	--	
Section 8 Documents			
1. Section 8 housing assistance payments contract	D	O	
2. Section 8 recapture agreement (if applicable)	D	O	
3. Assignment of rights in and to HAP contract (if sale of property)	D	O	
4. ACC between HUD and Contract Administrator	D	O	
Additional Documents			
1. Certification re: Notice and Administrative Actions	D	--	
2. Certification re: Sources and Uses of funds statement	D	--	
3. Sources and uses of funds statement	D	--	
4. Title evidence (endorsement of existing or new title insurance policy)	D	--	
5. Opinion of owner's counsel	D	--	
6. Transmittal letter to field office	D	--	
7. Subordination agreement (1 st mortgagee and 2 nd mortgagee, if applicable)	D	--	
8. Transfer of Physical Assets (TPA) documents	D	--	
9. Wiring Instructions	D	--	
10. HUD form required for release of funds in Reserves for Replacement account	D	--	
11. Agreement to increase replacement reserve deposits	D	--	
12. HUD Form 9250 funds authorization	D	--	
13. Consent of first mortgage	O	--	
14. Copy of certificate of occupancy	O	--	
15. Building permit for repairs	O	--	
16. Amendment to organizational documents	D	--	
17. Evidence of insurance	D	--	
18. Rent schedule (HUD Form 92458) *	D	D	
19. Recordation agreement	D	--	
20. List of attendees	D	--	

* Duplicate copy also sent to Section 8 administrator

KEY: O - Original; D - Duplicate

**TECHNICAL ASSISTANCE MATERIALS –
DRAFT FOR DISCUSSION**

IX. Servicing

The PAE is responsible for administering the Rehabilitation Escrow (for short-term repair requirements).

Public PAEs will generally serve as the property's Section 8 administrator, and will be responsible for long term compliance monitoring of the terms of the Use Agreement. In addition, the PAE may be selected to service the second mortgage.